THE PROGRESS OF THE LAW: CORPORATIONS

A summary statement of some 1919 or 1920 decisions on the law of corporations, with occasional comment, follows:

DISTINCTION BETWEEN A CORPORATION AND AN UNINCORPORATED BUSINESS UNIT

Crocker v. *Malley*.[1] By the terms of the federal income tax law of 1913 trustees were not liable to pay a certain tax upon dividends received from a corporation that was itself liable to a tax on its income, but such tax was payable by "every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships." The plaintiffs were trustees, and had received dividends from a corporation that was itself liable to a tax on its income. They were trustees of what would popularly be known as a business trust, and the terms of the trust were such that the persons entitled to the benefits of the trust were *cestui que trusts* and not partners. *Williams* v. *Milton*.[2] The taxes in question were assessed to the plaintiffs as a joint-stock association. The court held that they were entitled to recover the taxes so assessed, which had been paid under protest.

As the plaintiffs were trustees, and as trustees were not expressly made liable for such a tax,

"if they are to be subjected to a double liability the language of the statute must make the intention clear. . . . The trust that has been described would not fall under any familiar conception of a joint-stock association, whether formed under a statute or not. . . . It would be a wide departure from normal usage to call the beneficiaries here a joint-stock association when they are admitted not to be partners in any sense, and when they have no joint action or interest and no control over the fund. On the other hand, the trustees by themselves cannot be a joint-stock association within the meaning of the act unless all trustees with discretionary powers are such, and the special provision for trustees [in the income tax law] is to be made meaningless. We perceive no ground for

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[1] 249 U. S. 223 (1919).

[2] 215 Mass. 1, 102 N. E. 355 (1913).

grouping the two — beneficiaries and trustees — together, in order to turn them into an association, by uniting their contrasted functions and powers, although they are in no proper sense associated. It seems to be an unnatural perversion of a well-known institution of the law." [3]

The court also remarked that it presumed the double taxation was for the purpose of discouraging combinations by which one corporation holds controlling interests in other corporations which in their turn may control others, and that the facts showed that there was no such combination in this case.

The legal conception of a corporation is distinct from that of human beings who, as trustees, carry on a business; but the federal legislature might expose a corporation and business trustees to similar taxes, and it may well be that such legislation is desirable. The only question before the court was one of legislative intent. Tax laws must be strictly construed, and the law should not therefore be construed to tax the same business income twice, unless the intent to do so was clearly expressed.

Home Lumber Co. v. *Hopkins*.[4] A business unit was a trust, as distinguished from a partnership. *Williams* v. *Milton*.[5] The constitution of Kansas provided that the term "corporations" "shall include all associations and joint-stock companies having powers and privileges not possessed by individuals or partnerships," and the court held that the trust fell within this definition.

FORMATION OF CORPORATIONS

Schmitt v. *Kulamer*.[6] It is not illegal for an attorney employed to form a corporation to procure persons to sign the certificate of incorporation who are not intended to have any interest in the corporate venture. After the formation of the corporation such persons remain liable on their subscriptions contained in the paper signed by them until, but only until, they have transferred their stock with the consent of the corporation. Consent of the corporation is not necessarily shown by an entry upon its books.

Hess Warming & Ventilating Co. v. *Burlington Grain Co.*[7] This decision should be contrasted with the earlier decision in *Bank* v.

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[3] 249 U. S. 223, 233, 234 (1919).
[4] 190 Pac. (Kan.) 601 (1920).
[5] 215 Mass. 1 (1913).
[6] 110 Atl. (Pa.) 169 (1920).
[7] 217 S. W. (Mo.) 493 (1919).

Rockefeller,[8] which construed the Missouri statutes regulating the formation of corporations. They provided that the articles of agreement should set out the amount of the capital stock and "that the same has been *bona fide* subscribed, and one half thereof actually paid up in lawful money of the United States;" that a copy of the articles of agreement should be filed in the office of the Secretary of State, and that the Secretary of State "shall give a certificate that said corporation has been duly organized, and the amount of its capital, and such certificate shall be taken by all courts of this State as evidence of the corporate existence of such corporation." The plaintiff alleged that certain articles of agreement contained statements as to the capital subscribed and paid up which were false and were known by the subscribers to be false, and that therefore no corporation had been formed. But the court refused to hold that the legislature intended that the making of honest statements in the articles of agreement should be a condition precedent to incorporation, and held that the legislature intended the certificate by the Secretary of State should have all the force and effect of a legislative charter (the court at places speaks of the corporation as being a corporation *de facto*, but, on this interpretation of the statutes, it would of course be a corporation *de jure*, with its charter subject to forfeiture in *quo warranto*).

In the principal case [9] the court construed the Missouri statutes regulating the increase of capital stock. They provided that "any corporation increasing its capital stock shall, before the same shall take effect, cause to be paid up of such increase of capital not less than fifty per cent in lawful money of the United States;" that a statement should be filed in the office of the Secretary of State,[10] "who shall thereupon issue a certificate that such corporation has complied with the law — and the amount to which such capital stock is increased or decreased; and such certificate shall be taken in all courts of this state as evidence of such increase or decrease of stock, and thereupon the capital stock of such corporation shall be increased or diminished to the amount specified in such certificate."

A statement was filed in the office of the Secretary of State, stating that the full amount of an increase of capital stock had been

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[8] 195 Mo. 15, 93 S. W. 761 (1906).

[9] 217 S. W. (Mo.) 493 (1919).

[10] REV. STAT. MO., § 3356 (1909).

paid up; and the Secretary of State issued the certificate contemplated under this provision. The plaintiff wished to show that the statement was false, and that nothing had been paid on such increased stock. The court below gave judgment for the defendant; but the Supreme Court reversed this, distinguished the case from *Bank* v. *Rockefeller*, went behind the certificate, inquired into the fact of payment, and held the stock not to have been increased. It is submitted that the decision is right, and, moreover, that the statutory provisions here construed are similar to those construed in *Bank* v. *Rockefeller*, and that a like construction should have been given to the provisions there construed.

In the principal case, an unsecured creditor of a corporation obtained a decree cancelling a deed acquired by the purchaser at a foreclosure sale of corporate property given as security for certain second mortgage bonds. The statute forbade an increase of the bonded indebtedness beyond the amount of the "authorized capital." The alleged increase of stock was made as a basis for an increase of the bonded indebtedness. As the stock was not increased, these second mortgage bonds were held to be invalid. The purchaser at the foreclosure sale had actual or constructive notice that the stock had not been properly increased.

It should be added that the second mortgage bonds might also have been held to be invalid on other grounds mentioned by the court but not here discussed.

PAYMENT OF SUBSCRIPTIONS TO CAPITAL STOCK

Dee Co. v. *Proviso Coal Co.*[11] A and B conveyed their business to a corporation and received $25,000 par value of the corporation's stock in payment. The corporation became insolvent, and A and B were held liable to pay the difference between $25,000 and the actual value of the property transferred to the corporation. Judicial inquiry as to the actual value was made. The "good faith" of A and B was not questioned; but "payment with property for capital stock is no payment except to the extent of the true value of the property."

The conditions on which a corporation may issue stock are for the legislature to determine. It is a statutory question, not a common-law question.

[11] 290 Ill. 252, 125 N. E. 24 (1919).

Several legislatures have within the last decade authorized corporations to issue shares without a par value, and powerful arguments can be made for the wisdom of such legislation. So far as creditors are concerned there is, under such legislation, nothing to be said but *caveat creditor.*

If the legislature requires the corporation to have a par value — to put the dollar sign on the stock — it is conceivable that a legislature might nevertheless permit the stock to be issued on terms which had no relation whatever to such dollar sign. It might expressly authorize shares to be issued at a discount or for overvalued property. Such legislation is regrettable, but it is not beyond legislative competence.[12]

But the usual statutory situation is that the legislature requires a par value, and requires "payment" of that par value. The reasonable interpretation of such statutes is that the legislature did not intend the shares to be issued at a discount or for overvalued property, that a protection to creditors was contemplated, and that the legislative intent would be defeated unless there be payment in cash equal to the par value of the shares, or in property of a market value equal to the par value of the shares. Under such legislation a corporation would be unauthorized to issue stock at a discount, or for property taken by the corporation at a valuation in excess of its market value.

Despite the extraordinary English decisions and the decisions of many American courts made in the nineteenth century, the tendency of American courts, certainly since the decision of *See* v. *Heppenheimer*,[13] has been to insist upon an actual, as distinguished from a conventional, payment. The principal case so interprets the Illinois statute in question.

It may be added that, where stock is issued for property, and there is room for an intelligent difference of opinion as to the market value of that property, the value set upon the property by the corporation should stand, unless plainly wrong. This much leeway may well be given. But there was nothing in the facts of the principal case to bring it within such a rule.

Wallace v. *Weinstein*.[14] Under the law of Delaware a corporation cannot lawfully capitalize prospective profits.

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[12] See subd. 9 of § 1105 E of the Code of Virginia, 1904.

[13] 69 N. J. Eq. 36, 61 Atl. 843 (1905).

[14] 257 Fed. 625 (1919).

Zierath v. *Claggett*.[15] The court held that where stock was improperly issued for overvalued property, and the original subscribers were therefore liable to creditors, the same liability attached to all transferees of the stock. It did not distinguish between transferees who were *bona fide* purchasers of the stock and those who were not.

Statutes forbidding the issue of stock having a par value for overvalued property should be, and usually are, construed not to negative corporate capacity, but only to negative corporate authority to make such an issue. For if the transaction were held to be utterly void, the alleged subscribers, if sued to complete the payment of their subscriptions, would escape on the ground that they were not subscribers at all.

There has been an illegal transaction, and it is for the courts to apply an appropriate remedy. Such remedy is found by predicating the same results upon the transaction as would follow if there had been (1) a subscription to the stock, and (2) a separable agreement between the subscriber and the corporation that the shares should be deemed to be full paid although they were not in fact full paid. In such case the subscription would stand, and the agreement for a conventional payment would be stricken down as illegal, the payment actually made would be treated only as a payment on account, and the subscriber would be under liability to complete the payment.

If the original subscriber transfers his stock to a person having notice that the stock was improperly issued as full paid, the courts may reasonably impose upon the transferee an obligation similar to that which they impose upon the transferor. But it should be recognized that the liability both of the subscriber and of his transferee with notice is not predicated upon the actual agreement of the parties, but is imposed by law because the actual agreement was illegal.

A legislature might no doubt go further and make liable every holder of stock, including *bona fide* purchasers, if the stock had not been fully paid. And the recent case of *Shugart* v. *Maytag*[16] interprets the South Dakota statute as contemplating that result. But the imposition of such liability upon a purchaser of stock issued as full paid by the corporation who had no notice that it had been improperly so issued, goes beyond the bounds of what a court may

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[15] 188 Pac. (Cal. App.) 837 (1920).

[16] 176 N. W. (Iowa) 886 (1920).

reasonably do. The decision in the principal case is, it is submitted, plainly wrong.

The case is easily distinguishable from *Perkins* v. *Cowles*.[17] There stock had been issued, and there had been a payment of less value than the par value. The transferee was led by the representations of his transferor to believe that the stock had been issued as full paid by the corporation; but the transferee failed to establish that the corporation had issued it as full paid, or had represented that it was so issued. Under such circumstances the court properly held the transferee to be under a liability to complete payment. In that case the corporation had a claim against the subscriber for a further payment, and the transferee of stock issued as only partially paid must complete the payment if the corporation calls for such further payment while he is the holder of the stock. But in the principal case the corporation had issued the stock as full paid; there was no corporate asset for a further payment; such further payment could only be required through imposition of liability, and there is no proper basis for imposing such liability upon a person who was neither a party to the illegal transaction nor a purchaser with notice of the product of such illegal transaction.

The overwhelming weight of authority in this country is against the imposition by the courts of liability upon the purchaser of stock issued by the corporation as full paid who had no notice at the time of his purchase that it had been improperly so issued. For a recent case, see *Smoot* v. *Larsen*.[18]

PROMOTERS

Hart-Toole Furniture Co. v. *Shahan*.[19] Shahan was employed by persons who intended to form a corporation for the purpose of carrying on a furniture business. He supervised the preparation of a store, and appraised articles which the organizers wanted to purchase. After the services were rendered the corporation was formed, as planned, and the corporation, by its manager, agreed to pay plaintiff for these services. The court sustained a verdict for the plaintiff, on the ground that "the receipt of the benefit of past service is a sufficient consideration to support a subsequent agreement therefor" in such a case.

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[17] 157 Cal. 625, 108 Pac. 711 (1910).

[18] 189 Pac. (Idaho) 1105 (1920).

[19] 220 S. W. (Tex. Civ. App.) 181 (1920).

It is submitted that the result is right, but that it is unfortunate to base it upon such reasoning. When Shahan performed the services for the organizers, they were bound personally to pay him. All parties contemplated that the corporation, when formed, would take over the obligation of the organizers; if the corporation, when formed, promised Shahan to do so, there was a proper basis for predicating a novation, Shahan accepting the corporation as his debtor in place of the organizers.

Carle v. *Corhan*.[20] Plaintiffs owned a lease of real estate, a theatre license, and certain contracts and personal property. On November 29, 1916, they entered into a written contract whereby they agreed to sell all this property to "The American Theatre, Inc., a corporation in process of formation." The defendants Carle and Monjot intended to form such a corporation, and negotiated the purchase. To the contract were affixed the names of the plaintiffs, and the name "American Theatre Co. Inc., by F. Carle." Forthwith, part of the consideration was paid in cash, and the plaintiffs executed a transfer of the lease and license to the "American Theatre, Incorporated." On December 6, 1916, a paper was executed purporting to be a deed of trust conveying this property to a trustee to secure the unpaid purchase price represented by sundry notes. The deed of trust was signed "American Theatre Co. Inc. F. Carle Pres., Will Monjot, Sec." (The acknowledgment was in due form for an acknowledgment by a corporation.) The notes were signed in the same manner. On December 15, 1916, the American Theatre, Incorporated, became a legal unit. This corporation took over the property from the promoters, and assumed liability on the notes. The corporation thereafter paid the plaintiffs $100 on one of the notes, and gave a new note (presumably for the balance of the note on which $100 had been paid), signed in the same manner as the original note.

The court held that Carle and Monjot were not personally liable on the notes.

"There is a general rule that persons dealing with promoters of corporations to be thereafter formed are allowed the double security of the promoters and the corporation when it comes into being; but where it appears that the credit was extended solely to a corporation which was

[20] 103 S. E. (Va.) 699 (1920).

then in process of formation, and which shortly thereafter procured its charter, the rule does not apply." [21]

Outsiders may, at the instance of promoters, make an offer to a corporation to be formed which may be accepted by the corporation, when formed, if not previously withdrawn. But the transactions of November 29 and December 6 cannot fairly be construed as amounting only to this. The promoters wanted the outsiders to be forthwith bound; they wanted and received immediate delivery of the property, and the contract then made and the notes then given were their contract and their notes.

But where a contract is made by promoters avowedly in behalf of a corporation to be formed, the parties intend that the promoters shall serve only as a stop-gap, and it is proper to imply consent in advance by the outsiders to a novation whereby the corporation is to be taken in place of the promoter. If after the corporation is formed there are dealings between the outsiders and the corporation in which the corporation recognizes itself as bound, there is no reason why it should not be found that a novation has been accomplished (if the formalities are satisfied which are required by law for the kind of contract in question,—for example, if there be a writing where a contract is made relating to the sale of real estate).

If new notes had been issued in place of all the notes given on December 6, there would clearly be an end of the promoters' liability. And when the $100 was paid, and one new note was given, the trier of the facts might well find that the outsiders and the corporation impliedly agreed that their obligations and rights should be the same as though new notes had been given in place of all the old notes. This would give the promoters an equitable defense against liability on the old notes.

It may be added that, if the outsiders may fairly be held to have contracted in advance to take the corporation in place of the promoters, and the corporation, when formed, offers to take the place of the promoters, the refusal of the outsiders then to enter into a novation should be a defense to the promoters.

In *Kelner* v. *Baxter* [22] the argument was not made that the contract with the promoters might fairly be interpreted as contemplating a novation; and, moreover, after the company was formed there were no dealings between it and the outsiders, and it does not

[21] 103 S. E. (Va). 702, 703 (1920).

[22] L. R. 2 C. P. 174 (1866).

clearly appear even that the company offered to the outsiders to take over the liability in the place of the promoters.

In re Olympic Reinsurance Co.[23] An existing company offered its shares for public subscription. The offering was underwritten by A, and A made a sub-underwriting agreement with B. In consideration of the promise of payment by A to B of certain commissions, B agreed to subscribe for a certain number of shares in default of public subscription; handed A what the court found to be the equivalent of an application for shares; and agreed that the application should be irrevocable and that "this contract shall notwithstanding any withdrawal on our part be sufficient to authorize and empower the Directors to allot to us the above-mentioned shares and enter our name on the Register of Members in respect thereof." A handed the contract to the company. The question chiefly considered by the court was whether the directors had authority to allot the shares to B, in spite of and after an attempt by him to withdraw, and the court held that they had.

Here was a contract between A and B, under which B contracted with A that he would keep open an offer to C. If B has promised A to keep open an offer to A, A may accept, despite an attempted withdrawal, — the courts impose upon B the same consequences as would have followed if he had had the state of mind which he agreed to have. It is a step beyond that doctrine to hold that C, a beneficiary of the contract between A and B, may accept an offer of B's, which B has agreed with A should remain open to be accepted by C; but it is submitted that that step may properly be taken.

The court held B to be bound, but by a different process of reasoning. It said that B had given authority to A to carry out the sub-underwriting agreement; that this authority extended not only to the making of the application but also to the maintenance of the application to the date of its acceptance by the company, that such an authority was coupled with an interest (the interest of the underwriters to be partially relieved from the burden of their contract with the company), and therefore was irrevocable, relying on *Carmichael's Case.*[24] In that case the authority from B to A to apply for an allotment in the name of B was express, and was expressly

[23] [1920] 2 Ch. 341.

[24] [1896] 2 Ch. 643.

made irrevocable; in the principal case the court is of opinion that an intent to give an irrevocable authority is fairly to be implied.

It is an open question whether the American courts will follow this doctrine, but it is submitted that such a doctrine is unobjectionable as a matter of legal reasoning, and is highly desirable as a means of satisfactorily enforcing such agreements. If B, for a consideration, makes A his agent, and agrees that the agency shall be irrevocable, and it is intended by the parties that A shall be entitled to exercise this power for his own benefit, then there is not, in substance, any fiduciary relationship between A and B. A has not agreed to act for B; on the contrary, B has agreed that A may, in B's name, do an act for A's protection. Therefore all objection drops to imposing upon B the same consequences as would have followed if he had continued in the state of mind in which he agreed to continue.

DE FACTO CORPORATIONS

Pilsen Brewing Co. v. *Wallace.*[25] A corporation was duly formed, named the Farmers Grain and Feed Co. Thereafter there was an attempt to change its name to the Chicago Grains and Feed Co., but this was abortive, as all the statutory provisions were not complied with. Thereafter there was, in form, a contract made by the Chicago Grains and Feed Co. with the plaintiff. Held, that the attempted change of name had not destroyed the Farmers Grain and Feed Co., that it was bound on the contract made in the name of the Chicago Grains and Feed Co., and that the members of such corporation were exposed to no liability under the contract.

ULTRA VIRES TRANSACTIONS

McAlvaine v. *Foreman.*[26] Certain persons purported to organize a corporation with power to acquire a leasehold estate in land, to maintain and improve a building thereon, and to do certain other acts. The incorporators had no intention that the corporation should do any of the other acts. The Illinois statute did not authorize the organization of a corporation for the purpose of acquiring and holding real estate. In form, a corporation was

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[25] 291 Ill. 59, 125 N. E. 714 (1919).

[26] 292 Ill. 224, 126 N. E. 749 (1920).

organized and a lease of real estate was delivered in which the alleged corporation was lessee. It is not entirely plain from the opinion of the court whether it holds that a corporation was formed, but, assuming that a legal unit was formed, the court holds that it was *ultra vires* for it to acquire the lease. The lessor received rent under the alleged lease for 29 years. The court held that "where the act done by the corporation is beyond its legal powers the act is wholly void and of no legal effect and the legality of the act may be raised by any party affected by it"; and that the assigns of the lessor were entitled to a decree declaring the lease null and void and the claims of all persons claiming under said lease to be of no effect.

Brief comment on this case would be so inadequate that no comment is made.

Bishop Mfg. Co. v. *Sealy Oil Mill Co.*[27] A corporation operating cotton gins has authority to buy cotton seed from farmers, as part of a transaction in which the farmers bring their cotton to the corporation to be ginned, and to sell the cotton seed so obtained; but it has no authority to contract to sell at a future time an amount of cotton seed which it has not then on hand, and which is not based upon any estimate of the amount of seed which it can be foreseen, with reasonable certainty, will be acquired from customers. Such a contract would amount to speculating in the cotton seed market, is *ultra vires*, and the buyer cannot sustain an action for damages for failure by the corporation to deliver the cotton seed.

PURCHASE BY A CORPORATION OF SHARES OF ITS OWN STOCK

Gasser v. *Great Northern Ins. Co.*[28] If a corporation, upon an issue of its stock, promises to refund the money paid therefor unless it changes its place of business, and it fails to change its place of business, the stockholder may, "where no rights of creditors are involved," on tender of the stock, recover the money paid therefor.

The American law with respect to the purchase by a corporation of shares of its own stock is in an unsatisfactory condition.

At first blush, it may seem that if a corporation contracts to purchase shares of its own stock, and particularly if it makes this con-

[27] 220 S. W. (Tex. Civ. App.) 203 (1920). [28] 176 N. W. (Minn.) 484 (1920).

tract at the time it issues the stock, it ought of course to be liable on its contract. But this overlooks or overrides the fact that the stockholder and the corporation are not the only legal units to be considered. The creditors of the corporation must be considered, and this includes future creditors as well as present creditors.

Take the ordinary case of a corporation which is required to put a par value on its shares, to obtain payment, and to make a public record of the number of shares which it has issued. Such a corporation then has a specified amount of capital, and the legislature intended that this capital should be a margin of safety for creditors. To say that this capital is a trust fund for creditors is, perhaps, to make use of a confusing, and therefore an unhappy, phrase. But the important truth is that the corporation in dealing with its capital has not the same freedom of action that a solvent individual would have in dealing with his assets; it must, in obedience to the legislative intent, consider its creditors, present and future, in dealing with the assets which constitute its capital.

Most courts would concede that it was an elementary proposition of corporation law that this capital must not be returned to its stockholders (except in liquidation).

A solvent corporation may not pay dividends out of capital. It would make no difference if the corporation had expressly agreed to pay specified dividends when it issued its stock. Such a contract would be an unauthorized contract and unenforceable. Now a transfer of capital to one of the stockholders for a surrender of his stock has precisely the same effect upon creditors as a transfer of that amount of capital to all the stockholders by the payment of a dividend.

The objection to a purchase by a corporation of its shares out of capital may, perhaps, be phrased by saying that it is contrary to the legislative intent that the corporation should effect an unannounced reduction of its announced capital stock. But it is submitted that the preferable phrasing is that it is contrary to the legislative intent that the corporation should return any part of its capital to its stockholders or to any of them, except in liquidation.

May a corporation, then, never properly purchase shares of its own stock? There would seem to be no occasion for a sweeping rule to that effect, and a purchase would be proper under any of the following circumstances: (1) if the purchase were made from sur-

plus, and the stock carried no liabilities; (2) if the corporation were solvent, and it had statutory permission to reduce its capital stock, and the court, as a condition precedent to enforcing the contract, required the corporation to avail itself of this statutory permission so that the purchase price should be in fact paid out of a surplus which emerges through the reduction of the capital stock; (3) if the corporation were solvent, and were in liquidation so that the possibility of harm to future creditors might safely be dismissed as negligible. The leading case of *Dupee* v. *Boston Water Power Co.*[29] may be explained and sustained on this ground.

But the fact that the corporation intends and expects to reissue the stock, and so replace the assets now transferred to a stockholder, should not be enough to justify the purchase. *Non constat* that the expectation will be realized; if it is not, the creditors will find in the corporate treasury not assets but a piece of paper worth nothing to them.

It is submitted that the consideration of the problem by the court in the principal case is inadequate and unconvincing. Rights of creditors are necessarily involved in any return of capital to stockholders, even when that return is made pursuant to a contract, if the consideration given by the stockholder is simply a surrender of his stock.

Booth v. *Union Fibre Co.*[30] A corporation promised to redeem its preferred stock at a specified price upon a specified date. At such date its liabilities exceeded its assets. Held, that, although the corporation was not in liquidation and no creditor had asked relief, the holder of preferred stock was not entitled to the redemption of his stock. The necessary effect of a redemption would be to imperil the rights of creditors.

Johnson v. *Canfield Surgart Co.*[31] Corporate assets were paid to stockholders to such an extent that it became insolvent, and the public had no notice of the fact. The existing creditors were paid but only by creating other creditors in their place. The court held that the stockholders must refund. This is a development of the Illinois law a step beyond the doctrine of *Clapp* v. *Peterson.*[32]

[29] 114 Mass. 37 (1873).
[30] 171 N. W. (Minn.) 307 (1919).
[31] 292 Ill. 101, 126 N. E. 608 (1920).
[32] 104 Ill. 26 (1882).

DIRECTORS AND OFFICERS

Farwell v. *Pyle-National Co.*[33] A corporation acquired a license to manufacture and sell certain patented articles, and obligated itself to pay therefor a certain sum in cash, plus royalties on a specified basis. A director of the corporation purchased from the licensors an assignment of all their rights. This purchase was made for a consideration less than the actual value of the rights assigned, the director had acquired knowledge of the value by reason of his position, and the corporation was financially able to make the purchase itself at the time the director made the purchase. Held, that the benefit of the purchase belonged in equity to the corporation (subject to reimbursement of the director for the amount paid).

There is no rule that a director may never purchase from third persons the obligations of the corporation for his own account. But he must not compete with the corporation in the purchase of its obligations. And, if corporate obligations are for sale, it is the duty of the director to see to it that the corporation has the first opportunity to buy, if it is financially able to buy. It would seem to be sound to require a director, whenever he seeks to take advantage of the purchase for his own account of a corporate obligation, to prove that at the time of the purchase the corporation was either unwilling or unable to make the purchase itself.

Keely v. *Black.*[34] The Government wished telephonic service under the control of the Bell system provided to Camp Dix. The camp was in the territory of the Farmers Telephone Company, and an arrangement accomplishing what the Government desired was made between the Farmers Telephone Company, and the New York Telephone Company which was one of the Bell Companies. A part of this arrangement was that the president of the Farmers Telephone Company should acquire and turn over to the New York Telephone Company a controlling interest in the stock of the Farmers Telephone Company, and he was to receive a stated sum over the par of the stock for so doing. He owned some stock himself, he acquired at par all but eighty shares of the remainder, turned over his own stock and the stock so acquired, and received the agreed

[33] 289 Ill. 157, 124 N. E. 449 (1919). [34] 90 N. J. Eq. 439, 111 Atl. 22 (1919).

payment. The lower court held that he must pay to the Farmers Telephone Company the amount received by him in excess of the par value. The decree of the lower court was reversed, the court holding that he had not made a gain out of a sale of corporate property. "He had a perfect right, as an individual, to purchase the stock from the holders thereof at such prices as he and they should agree upon, and after buying it he was entitled to sell it again for such price as he and a purchaser should agree on." The court moreover noted that the bulk of the benefit of any such payment by him to the Farmers Telephone Company as the plaintiff sought would inure to the benefit of the Bell Company, as the owner of the bulk of the stock, and that such a result would be most inequitable.

If the whole arrangement involved two inseparable transactions, one a sale of the corporate property at less than its value to the Bell Company, and the other a payment to the president for the stock for more than its value, then the president would indirectly have benefited by a sale of the corporate property, and ought to disgorge his profit. But the upper court was satisfied that the transfer of the corporate property was on fair terms. "It is practically conceded by the complainant that it was a financial benefit to the Farmers Telephone Company to be released from the obligation of installing and operating this service."

Southern California Home Builders v. *Young*.[35] The court, construing a statute, held that if directors improperly declare and pay dividends, the corporation may recover from them the amount so paid, even if, without such recovery, the corporation is able to pay all creditors.[36]

Crohon & Roden Co., Ltd. v. *Rudnick*.[37] It was alleged in the declaration that a corporation had in its possession hides belonging to the plaintiff, and that it agreed that the identical proceeds from the sale of such hides should be turned immediately over to the plaintiff; that the defendant was treasurer of such corporation and well knew the terms of the contract between the corporation and the plaintiff, and agreed that the identical checks received from any sales should be turned over to the plaintiff; that the defendant

[35] 188 Pac. (Cal. App.) 586 (1920).
[36] See Appleton *v.* American Malting Co., 65 N. J. Eq. 375, 54 Atl. 454 (1903).
[37] 232 Mass. 544, 122 N. E. 741 (1919).

during the time he was treasurer received such checks, and "negligently and carelessly disregarding the rights of the plaintiff and his own promises . . . allowed said checks to be used for other purposes." Held, on demurrer, that the declaration stated no cause of action in contract, but did state a cause of action for the conversion of the checks.[38]

Leffert v. *Jackman*.[39] The Stock Corporation Law required the consent of the holders of not less than two-thirds of the stock to a mortgage of the corporate property. The officers of the corporation assumed in its name to give a mortgage on corporate property without procuring such consent. Held, that an assignee of the corporation for the benefit of creditors is entitled to have the alleged mortgage adjudged void.[40]

RIGHTS OF MINORITY STOCKHOLDERS

Otis-Hidden Co. v. *Scheirich*.[41] At common law a stockholder's right to inspect the books of the corporation covers all books and records, including correspondence concerning the internal affairs of the company between its nonresident president (who was the majority stockholder) and the manager.

Shea v. *Parker*.[42] A stockbroker purchased one share of stock in a Massachusetts corporation. He then asked to see the stock and transfer books, and for opportunity to take copies and abstracts therefrom. He desired to use the information to be so obtained in his business as a stockbroker to enable him when inquiries were made by prospective purchasers to ascertain if any of the shares were for sale, and in "broadening the market" for the stock. The court held that he was entitled to obtain such information even for such a purpose under the terms of § 30, c. 437, of the Acts of 1903.

"It may be presumed that before enacting the statute the Legislature considered the possibility that information thus obtained might as in the case at bar have a commercial value distinct and quite apart from the

[38] See, *accord*, Peruvian Guano Corporation *v.* Thompson, 99 S. E. (S. C.) 808 (1919).

[39] 227 N. Y. 310, 125 N. E. 446 (1919).

[40] *Cf.* Royal British Bank *v.* Turquand, 6 E. & B. 327 (1856); Louisville Ry. Co. *v.* Louisville Trust Co., 174 U. S. 552 (1899).

[41] 219 S. W. (Ky.) 191 (1920).

[42] 234 Mass. 592, 126 N. E. 47 (1920).

stockholder's interest as a corporate member, and undoubtedly could have made the right of examination dependent upon the motive actuating the stockholder. It has not however done so. The words conferring the right are unlimited, and the statute is mandatory."

Southern Pacific Co. v. *Bogert.*[43] The Southern Pacific Company controlled, through a subsidiary, the majority of the stock of the Houston Rail*way* Company. Pursuant to a reorganization agreement, mortgages were foreclosed, the properties were acquired by the Houston Rail*road* Company; the old company's bonds were exchanged for bonds of the new; the unsecured creditors were wiped out; the minority stockholders of the old company were given the right to acquire stock of the new company on the payment of $71.40 a share (said to be required to satisfy the floating debt and reorganization expenses and charges), which was a prohibitive assessment, while the Southern Pacific was enabled to acquire stock of the new company upon payment of an assessment of $26 per share (said to be the amount required to satisfy reorganization expenses and charges) and did acquire all this stock upon paying such assessment. The court required the Southern Pacific Company to deliver to minority stockholders a proper portion of the stock so received by it, with a sum equivalent to the dividends received therefrom, and interest thereon, upon their payment of the $26 a share and interest thereon.

Of course those who hold or control the majority of the stock of a corporation must not obtain an advantage out of any reorganization which is not open on equal terms to the holders of the minority stock. Although there had been much litigation over this reorganization, the disposition of the case called only for an application of this elementary principle, and this is so recognized by the court. The stock was received by the Southern Pacific Company in 1891, and this suit was not brought until 1913; but in the interval the plaintiffs, or some of them, had sought other relief from the reorganization, and the court holds that they are not barred by laches. "Nor does failure, long continued, to discover the appropriate remedy, though well known, establish laches where there has been due diligence and the defendant was not prejudiced by the delay."

The court sustained one contention of the Southern Pacific Company. That corporation showed that it controlled, through a sub-

[43] 250 U. S. 483 (1919).

sidiary, a large amount of the unsecured indebtedness of the old company, and the court, in effect, made an application of the principle of *Northern Pacific Ry. Co.* v. *Boyd*,[44] by requiring that some provision (the exact nature of which was to be determined by the lower court) should be made for giving priority over the stock of the new company to so much of the unsecured indebtedness of the old company as was controlled by the Southern Pacific Company. (The other holders of the unsecured indebtedness were not before the court.)

Brown v. *British Wheel Co., Ltd.*[45] A company was in great need of further capital. The majority, holding ninety-eight per cent of the shares, were willing to provide this if they could buy up the two per cent minority. The Companies Act provided that "a company may by special resolution alter or add to its articles, and any alteration or addition so made shall be as valid as if originally contained in the Articles." The majority proposed to pass an article giving the holders of ninety per cent of the stock power to require any other holder to transfer his shares to their nominee at a fair price (there was no question but that the majority were willing to pay a fair price). The court restrained the company from adopting the article. The court conceded that there would have been no objection to an original article in the form of the proposed article, but held that the provision permitting alterations must be interpreted to apply only to legal alterations, and that this alteration was illegal because not within the ordinary principles of justice and not for the benefit of the company as a whole.

A similar decision was made in *Dafen Tinplate Co.* v. *Llanelly Steel Co.*[46]

RIGHT OF A MINORITY STOCKHOLDER, SUING IN A REPRESENTATIVE CAPACITY, TO CONTROL THE LITIGATION

Bernheim v. *Wallace*.[47] In *Bernheim* v. *Louisville Property Co.*,[48] the plaintiff sued as a minority stockholder of the Louisville Property

44 228 U. S. 482 (1913).

45 [1919] 1 Ch. 290.

46 [1920] 2 Ch. 124. See the discussion of the rights of the majority and minority in 30 HARV. L. REV. 335.

47 186 Ky. 459, 217 S. W. 1916 (1920).

48 185 Ky. 63, 214 S. W. 801 (1919).

Company alleging mismanagement of its affairs by its directors, asking for the cancellation of certain deeds, an accounting from the directors and a majority stockholder, the appointment of a receiver and a sale of the corporate assets. The court held that the deeds should be canceled, and an accounting made, that there had been such mismanagement that directors elected or to be elected by the majority stockholder ought not to continue in the control of the affairs of the corporation, and said that it was "necessary for the court to assume control of the company's affairs through a receiver," and that "the properties should be sold by order of court" and the proceeds distributed to those entitled. The cause was remanded for an accounting and all proceedings necessary to a final settlement of the affairs of the corporation not inconsistent with the opinion of the court. Thereafter by agreement of all parties of record in the suit all the property of said corporation was transferred to a trust company, upon trust to sell and distribute the proceeds, and the parties asked the lower court to enter a judgment under which certain deeds of which the plaintiff had complained should be canceled, but which otherwise (with unimportant exceptions) contained no provisions for obtaining such other relief — including an accounting, the appointment of a receiver and a sale of the corporate assets — as the plaintiff had been adjudged by the higher court to be entitled to. The lower court refused to make such disposition of the case, and the petitioner asked the higher court to issue a writ of mandamus pursuant to which it would be the duty of the lower court to make such disposition of the case. The higher court issued the writ.

The plaintiff had sued in behalf of himself and of all other minority stockholders, and had been successful in his suit. The lower court was of opinion that, as the rights of the persons interested had been settled by the higher court, and as the plaintiff was suing only in a representative capacity, there should be a decree entered in conformity with the opinion of the upper court. The upper court recognized that, after the rights of the minority stockholders had been settled by its opinion, the plaintiff could make no settlement that would be prejudicial to the interest of other minority stockholders, or that would take from them any of the rights to which they had been adjudged entitled. But the upper court held that the rendering of the opinion did not produce a situation where the only

permissible course was to have such a decree entered in the lower court as the lower court would have entered pursuant to such opinion, if the parties themselves had not agreed upon some other disposition of the case; and that it was the duty of the lower court to dispose of the case, as the parties agreed, if the rights of the minority stockholders would thereby be as fully protected as under such a decree. And the court was of opinion that such protection was afforded under the plan agreed upon by the parties.

The trust company, the court said, could liquidate the affairs of the corporation more advantageously and with less cost to the parties interested than a receiver.

Under the plan agreed upon by the parties, the plaintiff's suit was to be dismissed without prejudice in so far as it sought an accounting and the recovery of money from certain defendants. But the court said that this feature of the plan did not vitiate it. "All of its property" had been conveyed by the Louisville Property Company to the trust company, and the court said this would include, without express mention, such claims, if any, as it had against the said defendants, that a dismissal of Bernheim's suit without prejudice left such claims unaffected, and that the trust company had the same right and duty to assert and recover these claims as a receiver would have had, and would be held to a strict accountability with respect thereto. The soundness of this portion of the opinion, and therefore of the decision, is questionable. Of course after the rendering of this opinion, the trust company would probably protect itself by asserting the claims, but, without such a statement from the court, the trust company might, as a practical matter, have thought its primary, if not its only, duty under the deed was to sell the real estate and distribute the proceeds. The agreed plan threw into the dim background the claims of the corporation against its directors and majority stockholder and it is only by benevolent assumption that one suppresses the suspicion that there was intent so to do. A sounder rule would seem to be that if a plaintiff, suing in a representative capacity, is adjudged entitled to certain relief, he may make no settlement of the case unless the plan of settlement, unaided by an explanatory exposition of its effect by a court, will clearly and in all respects protect the interests of those he represents as fully as would a decree entered in conformity with the opinion of the higher court without reference to any agreement between the parties.

RIGHTS OF HOLDERS OF PREFERRED STOCK

Michael v. *Cayey-Caguas Tobacco Co.*[49] A corporation, having eight per cent preferred stock and common stock, was dissolved in 1918. There had been no profits available for dividends since 1912, and no dividends had been paid since 1912. The assets were sufficient to pay the creditors, to pay the holders of preferred stock the par value of their stock, and to leave a balance which was less than the par value of the outstanding common stock. The question was whether the holders of the common stock were entitled to the whole of this balance, or whether the holders of the preferred stock were entitled from this balance to a sum equal to eight per cent per annum of the par value of the preferred stock from the date of the last dividend payment in 1912 to the date of payment. The court held that the holders of the common stock were entitled to the whole of the balance.

The provisions governing the preferred stock stated that "the holders of preferred stock shall be entitled to receive, when and as declared, from the surplus or net profits of the company, a fixed yearly cumulative dividend of, but not exceeding, eight per centum per annum. . . . In case of liquidation or dissolution of the company prior to redemption of the preferred stock, the surplus assets and funds of the company shall be applied, first, to the payment in full [of the] par value of said preferred shares, and all accrued and unpaid dividends thereon, and after such payments, the remainder of the surplus assets and funds of the company shall belong to, and be divided pro rata among, the holders of the shares of common stock."

Under the Stock Corporation Law, no dividends could be paid except from the surplus profits arising from the business. The assets were less than debts and the par value of the preferred and the common stock, therefore there was no fund available for the payment of dividends. The effect of the provision for cumulative dividends was restricted by the court to giving a charge upon subsequent profits. The thought of the court was that no dividend accrues until there is a fund available for its payment.

The holders of the preferred stock probably expected, in case of a dissolution, to receive (before any payment was made to common

[49] 190 App. Div. 618, 180 N. Y. Supp. 532 (1920).

stockholders), in addition to their capital, a sum of money equal to dividends at the prescribed rate over the period when no such dividends had been paid. Strictly, such a payment would be interest, and not dividends.

The decision shows the need of carefully wording the provisions which are intended to assure preferred stockholders of a claim, superior to any rights of common stockholders, to the repayment of their capital, and the ultimate payment of an income therefrom at a stated annual rate. Although it is *ultra vires* for a corporation to guarantee dividends, there would seem to be no objection to an agreement by a corporation that, in case of dissolution, it will pay a stipulated rate of interest to preferred stockholders in lieu of unearned dividends before any payment is made to common stockholders.

In re Fraser & Chalmers, Ltd.[50] On the issue of preference shares it was provided that in the event of a winding up the holders "shall have a preferential right as regards repayment of capital — and accordingly shall be entitled to have the surplus assets applied, First, in paying off the capital paid up on the preference shares held by them respectively, and secondly, in paying off the arrears (if any) of the preferential dividend aforesaid — before any return or payment of capital is made to the holders of the other shares." [51]

In a winding up, it turned out that, after payments of all liabilities, preference capital and arrears of preference dividends, and ordinary capital, there was a surplus. The holders of the preference shares were held to be entitled to participate in the distribution of this surplus.

TRANSFER OF SHARES

Crosby v. *Simpson*.[52] The owner of a stock certificate signed the transfer in blank on the back, with the words "as collateral." "The plaintiff's ownership, shown on the face of the certificate, coupled with his signature to the transfer in blank preceded by the words 'as collateral' was sufficient notice to all persons that the transfer was conditional."

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[50] [1919] 2 Ch. 114.

[51] *Ibid.*, 117.

[52] 234 Mass. 568, 125 N. E. 616 (1920).

Boston Tow Boat Co. v. *Medford National Bank.*[53] In 1902 a certificate for shares of stock in the Boston Tow Boat Company standing in the name of Susan M. Stuart, with what purported to be a blank transfer and power of attorney signed by her, were pledged with the Medford National Bank, as security for notes which purported to be signed by her. In compliance with an order which purported to be signed by Mrs. Stuart, the bank caused the shares to be sold, and the certificate and the transfer and power of attorney were presented to the Boston Tow Boat Company, were canceled, and new certificates were issued in the names of the purchasers. The alleged signatures were forgeries, and in 1902 Mrs. Stuart brought suit against the Boston Tow Boat Company, and a decree was ultimately entered in her favor for $6000, and this amount was paid in 1915. The Medford National Bank had been notified to defend the Stuart suit. A receiver of the Boston Tow Boat Company now seeks to compel a trust company which had succeeded to the liabilities of the Medford National Bank to pay the money it paid to Mrs. Stuart, and the expenses incurred in defending her suit. The court held that the receiver was barred by the Statute of Limitations. Its reasoning was that one who surrenders a share certificate bearing a forged indorsement, and obtains a new certificate in ignorance of the forgery, is liable upon an implied warranty of the genuineness of the signature; but that the liability is upon an implied warranty, and not upon an implied contract of indemnification (the court reasoned that such an indefinite and protracted contract of indemnity may not properly be implied from the innocent presentation of the forged transfer), and that the warranty was broken as soon as made, in 1902. The court notes that the breach was discovered by the corporation in 1902 when Mrs. Stuart brought suit.

There is a similar decision in *Pennsylvania Lehigh Coal Co.* v. *Blakeslee.*[54] But in *Sheffield Corporation* v. *Barclay,*[55] the forged transfer was presented in 1893, the forger died in 1897 and the forgery was then discovered,[56] but the report does not state whether the corporation was then informed of the discovery. In 1900, the owner sued the corporation, and recovered, and the corporation then sued the person who had presented the forged transfer, and was allowed to recover. Lord Davey said:[57]

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[53] 232 Mass. 38, 121 N. E. 491 (1919).

[54] 189 Pa. 13, 41 Atl. 992 (1899).

[55] [1903] 1 K. B. 1; [1905] A. C. 392.

[56] See [1903] 1 K. B. 3.

[57] [1905] A. C. 392, 404.

"I can see no legal reason why, in circumstances like those of the present case, it should not be held, if necessary, that the true contract to be implied from those circumstances is not only a warranty of the title, but also an agreement to keep the person in the position of the appellants indemnified against any loss resulting to them from the transaction. And I think that justice requires we should so hold."

DISSOLUTION

State v. *Gamble-Robinson Fruit Co.*[58] A civil remedy in the nature of *quo warranto* to procure the annulment of corporate franchises for an abuse of its powers, such abuse consisting in the doing of acts which are by statute made criminal, is not conditioned on a successful criminal prosecution under such statute.

EFFECT OF REORGANIZATION UPON CONTRACT RIGHTS

Kansas City Soap Co. v. *Illinois Cudahy Packing Co.*[59] The plaintiff and defendant contracted for the sale of goods by the defendant to the plaintiff on credit. The plaintiff thereafter assumed to convey all its property to a new corporation and the successor corporation undertook to discharge its debts. The plaintiff thereafter tendered the contract price of the goods to the defendant, who refused to deliver. Held, that the contract right could not be assigned, that it continued in the plaintiff despite the attempt to convey all its property, and that the plaintiff had not by transfer of its property so disabled itself from performance as to discharge the defendant.

TAXATION

De Ganay v. *Lederer.*[60] A citizen of France owned shares of stock in corporations organized in the United States. The certificates were in the hands of an agent in the United States, who had power to collect the income and to sell. Held, that the shares were "property . . . owned in the United States" by a person residing elsewhere, within the meaning of the federal income tax law of 1913.[61]

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[58] 176 N. W. (N. D.) 103 (1919).
[59] 265 Fed. 108 (1920).
[60] 250 U. S. 376 (1919).
[61] *Cf.* Kennedy *v.* Hodges, 215 Mass. 112, 102 N. E. 432 (1913).

Wilder v. *Tax Commissioner*.[62] A corporation was in arrears to the extent of thirty-three and one-half per cent in declaring and paying the six per cent cumulative dividends provided for by the terms of its preferred stock. It, in form, declared a dividend upon such preferred stock, payable seven and one-half per cent in cash, fourteen per cent in preferred stock, and twelve per cent in common stock. The plaintiff accepted such cash and stocks. The court held that the value of the stocks so received was taxable, under a statute taxing "dividends on shares in all corporations."

But by chapter 352 of the Acts of 1920, the Massachusetts legislature has now provided that dividends "other than stock dividends paid in new stock of the company issuing the same" shall be taxable.

Osgood v. *Tax Commissioner*.[63] A tax was assessable upon gain "from purchases or sales of intangible personal property whether or not the taxpayer is engaged in the business of dealing in such property." A corporation issued both preferred and common stock. The directors caused another corporation to be organized, and all the holders of stock, preferred and common, of the first corporation exchanged their stock for the common stock of the second corporation. The first corporation then transferred all its assets to the second, which continued the business through the same officers and without outward indication of change. The petitioner exchanged some preferred and some common stock of the first corporation for common stock in the second, and was held taxable on the difference between the value of the stock given in exchange on January 1, 1916 (a date fixed by the statute in question) and the value of the stock received in exchange.

There was a change in the taxpayer's rights, not only in legal form but also in business substance.

"Although the property owned by the new corporation was identical with that owned by the old corporation, it nevertheless plainly was a different legal entity. . . . The stock obtained by the petitioner through exchange was different in kind and not merely in degree from that which she owned before. It was not the same corporation and the stock itself was different in nature. A change of investment had been made both in name and in essence." [64]

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[62] 234 Mass. 470, 125 N. E. 689 (1920). [63] 235 Mass. 88, 126 N. E. 371 (1920).
[64] *Ibid.*, 91.

As to the taxation of a business trust, see *Crocker* v. *Malley*, *supra*.[65]

As to the taxation of stock dividends as income by the federal government, see the article in 33 HARVARD LAW REVEIW, 885, on "Taxability of Stock Dividends as Income."

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[65] 249 U. S. 223 (1919), *supra*, note 1.